RESEARCH REPORT

NOVEMBER 20, 2002

Changes in Global Trade Rules for Textiles and Apparel

Implications for Developing Countries

NATHAN
ASSOCIATES INC.

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SUBMITTED TO
USAID/Washington

SUBMITTED BY
Nathan Associates Inc.
TCB Project

UNDER CONTRACT NO.
PCE-I-00-98-00016, Task Order 13

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Nathan Associates Inc.
Support for Trade
Capacity-Building Activities
Arlington, Virginia

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Summary

Developing country exporters of textiles and apparel face significant challenges that are likely to dramatically change the global market:

- Elimination of quotas by 2005 under the World Trade Organization's (WTO) Agreement on Textiles and Clothing (ATC);
- China's accession to the WTO and its resulting access to major markets in which it was previously constrained by quotas;
- The proliferation of preferential access agreements and the changing nature of the preferences they accord (e.g., tariff preferences will replace quota preferences as the primary benefit of preferential access); and
- The likelihood that countries will increase antidumping, countervailing duties, and safeguards to deal with market disruption.

For more than 30 years, exports of textiles and apparel between developed and developing countries have been tightly regulated by quotas. Shielded from competition by quotas, many of the poorer and smaller developing countries have built substantial export sectors, realized foreign exchange income, and created substantial numbers of jobs in sectors in which they might not otherwise have been competitive.

While developing country exporters are likely to receive net benefits from elimination of textile and apparel quotas by 2005, these benefits are likely to be concentrated in the hands of a few large low-cost producers, such as India, Pakistan, and China. Conversely, many smaller developing countries face the prospect of dramatically reduced exports.

Two key facts emerge from analysis of U.S. quota elimination. First, ongoing liberalization of textile and apparel quotas has produced rapid shifts in market shares, with Asian countries (including China) gaining significant market share, mainly at the expense of Mexico and other developing countries. Second, some countries and regions are exposed to a higher risk of losing market share in the new, more liberal trade environment for textiles and apparel. Among suppliers to the U.S. market, Mexico and countries in the Caribbean and sub-Saharan Africa that benefit from preferential access under programs, such as the Caribbean Basin

Initiative (CBI), North American Free Trade Agreement (NAFTA), and the African Growth and Opportunity Act (AGOA), are at a particularly high risk.

China's accession to the WTO is already producing major shifts in global production and distribution systems. Chinese producers are poised to increase their market share substantially in the United States and other markets where access is controlled by quotas. Trade data of the first six months of 2002, and the recent pattern of Chinese textile trade with the advanced market of Japan, which has no textile quotas, suggest that China's WTO accession will have a substantial impact on other textile- and apparel-exporting countries.

Preferential trade agreements have proliferated in recent years. Preferential trade agreements have helped encourage the development of apparel assembly operations in many developing countries, as apparel producers have looked for low-cost production sites that could also give them quota access to U.S. and EU markets. Without the quota system, however, preferential trade agreements will become less important to producers deciding where to locate their apparel assembly operations.

Countries with preferential trade agreements with developed country markets have enjoyed greater inflows of capital, technology, and managerial expertise than countries without such agreements. When quotas are eliminated, preferential trade agreements will still provide tariff advantages but these benefits are likely to be far less significant than quota benefits have been. U.S. textile and apparel tariffs remain high, but they are not prohibitive[1]. The average U.S. duty on apparel items is 17 percent. This provides only a thin margin of preference over producers not receiving preferential access—a margin that in some cases may be less than the production cost advantages that large Asian suppliers may enjoy vis-à-vis preferential suppliers in the Caribbean, Africa, and Mexico.

Countries that have developed sizable apparel assembly operations based on preferential trade agreements with the U.S. and EU markets risk losing significant apparel manufacturing capacity as investors search for locations that offer other advantages, including lower manufacturing costs. Preferential trade agreements are no substitute for a country's fundamental evaluation of its sectoral competitive advantage, especially if it is heavily dependent on apparel exports.

To date, the use of trade remedies, such as antidumping, countervailing duties, and safeguards, has been limited in the textiles and apparel sector, in part because quotas effectively regulated imports to developed countries and maintained prices at super-competitive levels. With the continuing phase-out of quotas, world exports have been rising and prices have been declining. As prices become lower, producers in developed and developing countries alike may turn to trade remedies to protect their local producers. Many

[1] A major thrust of new trade negotiations is to lower peak tariffs on non-agricultural products.

developing countries may be tempted to subsidize production to maintain market share in textiles and apparel.

Faced with these seismic changes in global market conditions, countries that depend on textile and apparel exports should seriously assess their competitiveness against the major low-cost Asian suppliers and develop strategies to adjust. Even where it appears that producers have the potential to remain commercially viable in this new environment, they will need to work hard to improve their competitiveness. These activities must seek to optimize all of the factors that contribute to a producer's ability to supply competitively priced products that respond to market demands. Factors to be considered for alignment with world standards include: tariffs and trade policies affecting imports of raw materials and fabrics; investment incentives; efficiency and transparency of customs processing; availability and cost of transport, communications, energy, water, and other physical infrastructure; labor laws; tax rates; wages; and productivity. Countries will also need to

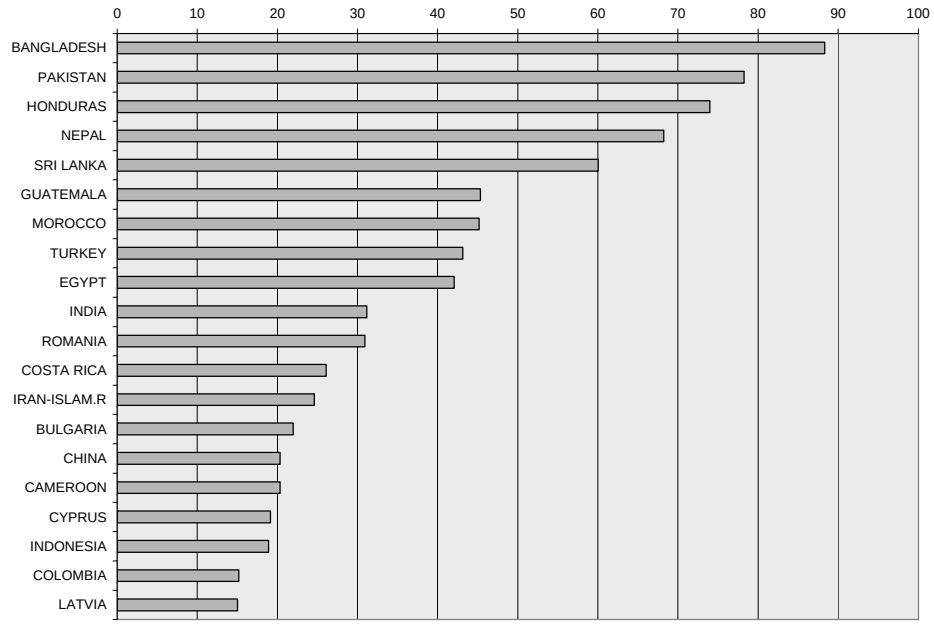
- Ensure that their labor practices conform to international labor standards,
- Avoid pressures to subsidize textile and apparel operations to keep prices competitive with low-cost producers,
- Encourage industrial diversification to reduce dependence on textile and apparel industries and to nurture other opportunities to create jobs for urban workers, and
- Develop training programs and social safety nets for displaced workers.

The organization of this paper reflects the challenges of the recent changes in global trade rules for textiles and apparel. We first discuss the importance of the textile and apparel sector to developing countries' manufacturing export share and employment. We then examine the effect on exporting countries of the growth and removal of quotas under the ATC and China's accession to the WTO and its access to developed country markets—an event that will reshape the global textile industry. We then consider the changing nature of preferential trade agreements and the greater use of trade remedies—antidumping, countervailing duties, and safeguards—to curb market disruption caused by unfair trade in the textile and apparel sectors. To conclude, we identify several areas where USAID missions can offer assistance to countries that have significant textile and apparel exports.

1. Textiles and Apparel Trade

Many developing countries have come to rely on textiles and apparel to generate national income and create jobs. For at least a dozen developing countries, textiles and apparel account for more than 25 percent of manufacturing exports and more than 60 percent for countries such as Bangladesh, Honduras, Pakistan, Nepal, and Sri Lanka (see Figure 1).[2]

Figure 1
Textile and Apparel Exports as a Percent of Total Merchandise Exports (Excluding Oil\Gas)

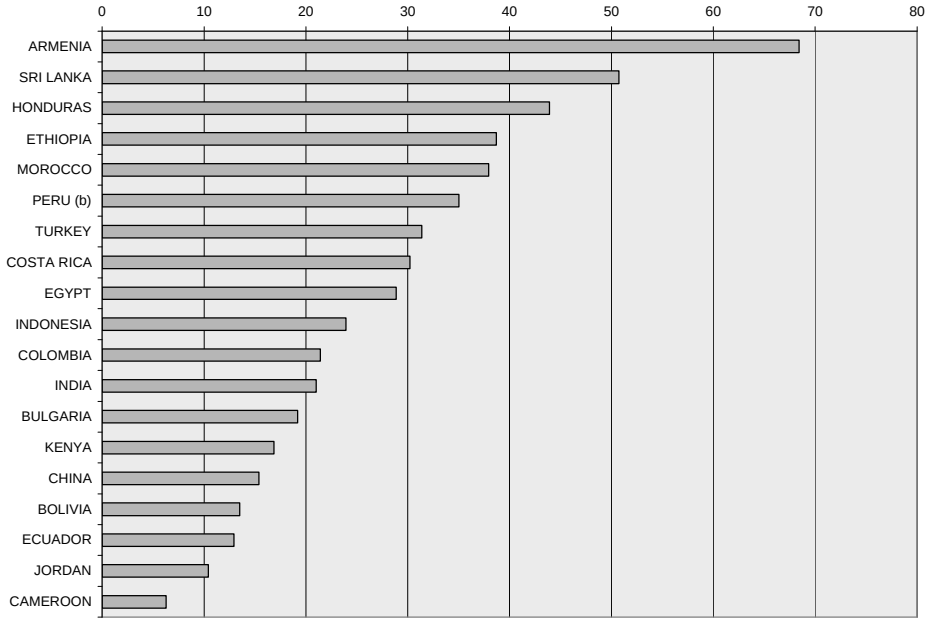


SOURCE: World Bank Trade and Production Database. Data for 1998.

[2] The three basic elements of the textile and apparel value chain are textile production, clothing "assembly," and final distribution and sales. Although we discuss all phases of production in this paper, the focus is apparel production. Of the poorest developing countries, only Egypt, India, Pakistan, and Bangladesh have significant direct textile exports to developed markets. However, to assess the impacts of the sector on employment, each USAID mission should review local textile capacities and their relationship to apparel destined for the major developed markets (indirect exports). Often these data can be obtained only through field research. Changes in the global apparel trade will also have significantly greater effects on employment because apparel construction is much more labor-intensive than textiles production.

The textile and apparel sectors are the largest generators of unskilled manufacturing employment (see Figure 2). Light and medium manufacturing industries such as textiles and apparel are essential in breaking the cycle of poverty in developing countries. They offer unskilled labor the first step out of the informal sector, which is characterized by underemployment, low education, subsistence wages, and labor abuses and discrimination. Moreover, these jobs create opportunities for segments of society—women and children—that often have few options. Even in countries where alternative sources of foreign exchange earnings exist, such as tourism, oil exports, or repatriation of foreign capital by migrant workers, light manufacture exports are considered crucial in generating employment for unskilled labor, which in turn contributes to political and economic stability (Jessen and Rodriguez 1999).

Figure 2
Textiles and Apparel Employment as a Percent of Total Manufacturing



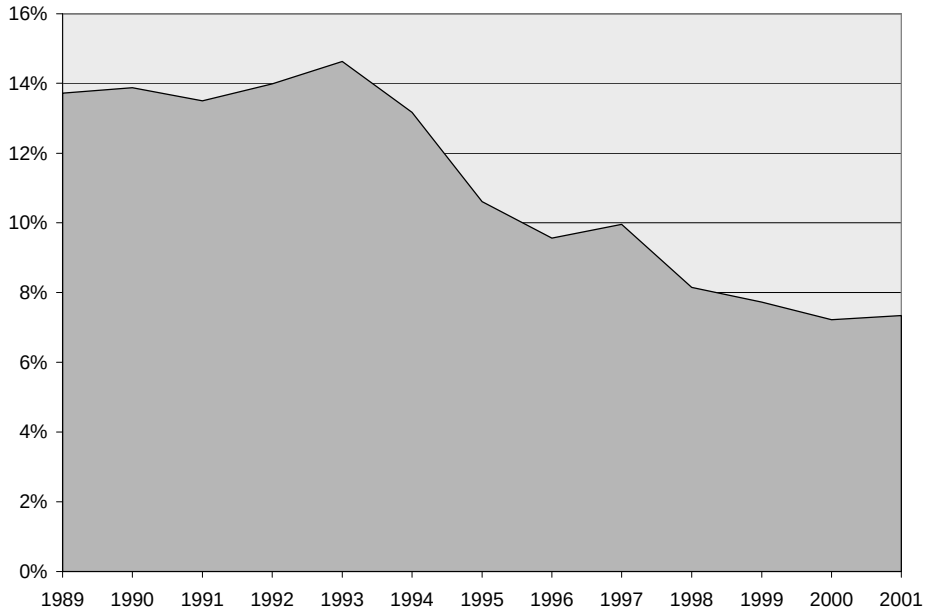
Source: World Bank Trade and Production database, 1995.

Note: Measuring employment in textiles and apparel is problematic because of the prevalence of small and medium enterprises, large numbers of workers employed in the informal sector, and the existence of export processing zones with transnational clothing firms that often do not welcome government-sponsored surveys. Therefore, official estimates included in this report likely underestimate the importance of textile and apparel employment in total manufacturing employment. It is therefore likely that many more small developing countries than those listed here depend heavily on textiles and apparel exports for employment (e.g., such as Cambodia and Bangladesh).

The existence of quotas in the international textiles and apparel trading system for the past half century has in effect shielded textile and apparel-exporting countries from competition and granted them relatively predictable export earnings by guaranteeing market shares. As a result, developing country governments have been able to use quotas to further particular development objectives such as rural and indigenous employment and small and micro-enterprise development (Krishna and Tan 1998; Weerakoon and Wijayasiri 2000).

Quotas have also permitted many smaller, less competitive countries to participate in international trade, providing them with economic and social benefits such as foreign direct investment, construction, transportation, communication infrastructure, employment, and foreign exchange earnings. It is estimated that one direct job created in the textiles and apparel industry can lead to two supporting (or indirect) jobs in service and supplier industries (U.S. International Trade commission 2001). The share of developing countries—such as Nepal, Sri Lanka, Honduras, Morocco, and Tunisia, among others—in developing countries' markets would have been much less if quotas had not severely restricted the exports of efficient producers, such as China, Korea, Indonesia, and India. For example, smaller developing countries increased their share of the U.S. market while China's market share in quota-constrained categories was reduced by one-half during 1989–2001 (see Figure 3).

Figure 3
China's Share of U.S. Apparel Imports, 1989–2001 (Import Market Shares Based in Volume)



SOURCE: Calculations based on data from the U.S. Department of Commerce OTEXA office.

The quota system has rarely encouraged or induced higher productivity and lower costs. It has actually perpetuated labor rigidities in some respects because it has protected countries from loss of market share and earnings.[3] The revenue stream guaranteed by quotas has allowed companies to keep ineffective or even negligent workers on their payrolls (James,

[3] Labor rigidities are due in part to local politics and to responses to highly visible cases of labor abuse in textile and apparel industries.

Ray and Minor 2002)[4]. In some developing countries, this has led to bloated, inefficient enterprises that operate far below best international standards for productivity and costs, for example, by employing thousands more workers than are needed. More important, it has robbed entrepreneurs of their motivation to invest in more efficient equipment and worker education and skills training, or to pursue more productive activities in other sectors.

Whatever the rights or wrongs of the quota system from the perspective of developing countries, the rules are changing, and the productivity distortions that have built up over the years in many countries need to be addressed urgently despite the difficulty of doing so (Kathuria, Martin and Bhardwaj 2001). When quotas are eliminated in 2005, even the lowest-wage, international producers will have to rationalize production methods and wages to conform to the best world standards. Producers that cannot meet these standards will suffer reduced sales and market shares.

[4] Rigidities in labor markets and low labor productivity do not mean that labor in the sector is treated well; indeed, labor abuses in the industry are widely reported.

2. Agreement on Textiles and Apparel

Trade-distorting quotas have governed trade in textiles and apparel for most of the past half century. The WTO's Agreement on Textiles and Clothing (ATC), negotiated during the Uruguay Round, and effective January 1995, is the basis for reintegrating trade in textiles and apparel into the world trading system, which generally prohibits non-tariff barriers such as quotas. Under the ATC, transition to quota-free textile and apparel trade is to occur over a 10-year period, ending December 31, 2004[5].

Phase-out of the Quota System

The ATC provides two mechanisms for eliminating quotas: (1) phased removal of quotas and (2) accelerated quota growth rates to take place in four stages (see Table 1).

Table 1
Stages of U.S. and EU Textile and Apparel Quota Phase-out

Stage	Component 1	Component 2	
	Share of importing country's textile and apparel trade to be free of quota (% of 1990 import quantity)	Annual increase in remaining quota growth rates (%)	Example: How fast remaining quotas would open up if pre-ATC quota growth rate had been 6 %
I 1995–1997	16	16	6.96% p.a.
II 1998–2001	17	25	8.7% p.a.
III 2002–2004	18	27	11.05% p.a.
IV 2005 (final)	49	No quotas left	No quotas left

SOURCE: U.S. Department of Commerce Office of Textiles and Apparel: http://otexa.ita.doc.gov.

[5] Quotas will remain on a small number of non-WTO countries, such as Vietnam. Also, trade remedies may take a "quota like" form.

The first two stages of quota elimination had no sizeable effects on producers or importing markets because quota removal applied principally to products that had not been constrained by quotas so imports were generally below quota levels. Changes between 2002 and 2005 will likely have much greater impact. Indeed, tariff lines accounting for 49 percent of trade, including the most restrictive quota categories (based on 1990 import volume), will be liberalized only in the tenth year (January 1, 2005).[6]

IMPACT OF QUOTA ELIMINATION

Competition among exporters of textiles and apparel in developing countries will intensify during Stage III (2002–2005). The issue of which product categories and countries are quota-constrained and which are not is crucial to understanding how particular countries will fare in the last two stages of quota elimination. It is also crucial to appreciating how the speed of reorganization and adjustment in global textile trade will intensify after December 31, 2001, especially after December 31, 2004. China's WTO accession, as discussed in Section 3, is the other major intensifying factor.

Many countries and products are included in the quota system, but only a small number of countries and products are actually constrained by quotas because many countries do not use quotas to the fullest extent.[7] Elimination of an unfilled, non-constraining quota has little effect on a country's ability to export, because it could have continued to export to the quota limit in any case. Elimination of constraining quotas has been largely deferred to Stages III and IV.

Table 2 presents the expected weighted average annual growth rates for U.S. textiles and apparel imports in quota-constrained categories filled in 2001 by the supplying region during Stage III (2002–2005).[8] With average annual quota growth rates of 9 percent or more for most regions, competitive pressures will escalate significantly in 2002–2005.[9]

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[6] Not all developing countries take the same position on WTO negotiations over trade in textiles and apparel. For example, last year, a group of developing country members led by India, China, South Korea, and Hong Kong proposed an accelerated quota elimination schedule. The United States and EU declined to include an accelerated schedule. Had the proposal been accepted, the resulting debate would have likely pitted smaller developing countries and preferential suppliers against the low-cost Asian producers, since the benefits of an accelerated phase-out would likely accrue to the large producers in Asia to the detriment of smaller producers.

[7] Industry experts define a quota as restrictive or "constraining" if it is filled to between 85 and 90 percent. Although this level is still below the maximum allowed export limit, complexities in the quota management system (including complex aggregates) can make it difficult to completely fill a quota (USITC 2002). The EU defines quotas 95 percent filled as constraining.

[8] No growth rates are applicable to sub-Saharan Africa (SSA) and members of the North American Free Trade Agreement (NAFTA) because the limited quotas that affected them were removed in 2001.

[9] Quota growth on EU textile and apparel imports from developing countries is reported to be slightly lower than in the United States (Kheir-El-Din 2002).

Table 2
Weighted Average Growth Rates for U.S. Imports of Textiles and Apparel

Region	2002–2005 Weighted Average Growth Rate on Constraining (Filled) Quotas (%)
Asia	9
CBI	12
SSA	--
NAFTA	--
China	3
Others	11

SOURCE: U.S. Department of Commerce Office of Textiles and Apparel.

Note: Quotas are defined as restricting if 85 percent or more of the category was filled in 2001. Other regions include importers, principally in South America, Europe, and Japan.

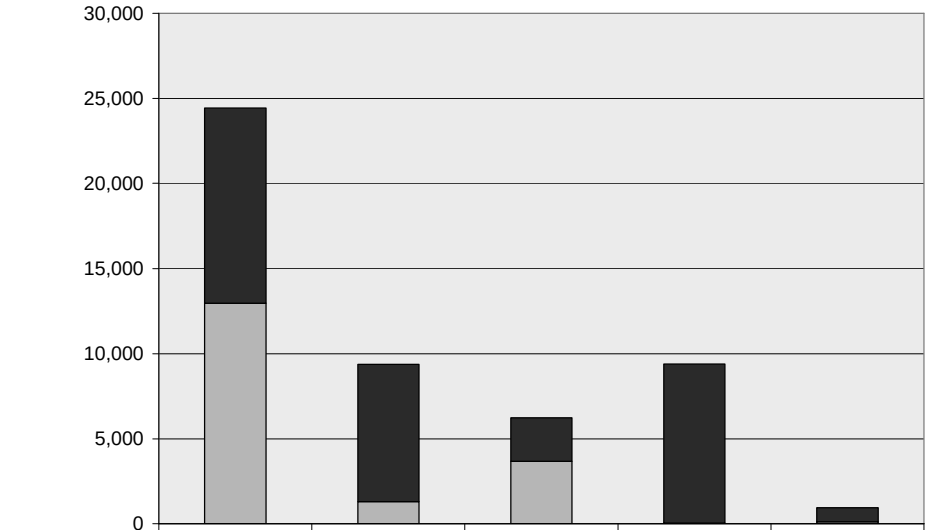
REGIONAL VARIATIONS IN THE IMPACT OF QUOTA REMOVAL

Few suppliers of textiles (yarns and fabrics) are constrained by quotas. But significant constraining quotas remain in the apparel sector where competition will intensify when quotas are removed in 2005. The degree to which quotas constrain suppliers' exports varies by region (see Figure 4). For example, U.S. imports from Mexico under NAFTA and from sub-Saharan Africa under AGOA have virtually no constraining quotas, and less than 15 percent of Caribbean countries' exports to the United States under the Caribbean Basin Initiative (CBI) are constrained. In contrast, more than half of Asian and Chinese exports of apparel to the United States are constrained by quotas.

Suppliers that are not significantly constrained by quotas, such as countries benefiting from preferential trade agreements, have an advantage over quota-constrained suppliers. Several studies estimate the tariff equivalent of quotas on Chinese and Asian exporters—that is, the tariff level that would have the same restrictive effect as the quota—to be on the order of 40 percent or more (Kathurina, Martin, and Bharwaj 2001; USITC 1999). This advantage will disappear, however, as quotas are phased out and quota growth rates are accelerated over the next few years. Figure 5 compares U.S. imports of apparel by region based on the risk of market share losses in 2005. The risks are categorized as low, moderate, and high.

- ***Low*** products for which the ATC has eliminated quotas or for which no constrained suppliers exist. Products in this category are affected principally by market forces.
- ***Moderate*** products that will have restraining quotas eliminated. Suppliers may be affected positively or negatively by quota removal, depending on a supplier's competitive abilities compared with those of other constrained suppliers.
- ***High*** products for which producers in the given region are not restrained by quotas, but producers in other regions are restrained by quotas.

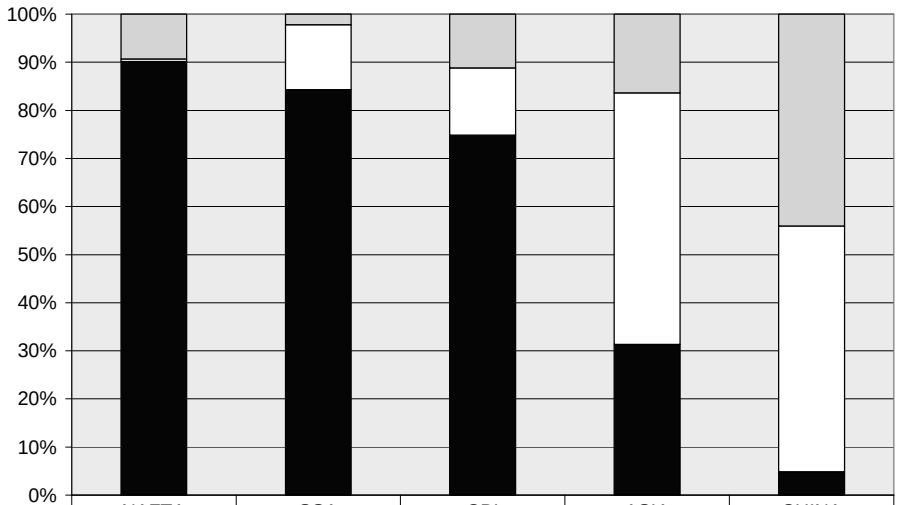
Figure 4
Regional Differences in Quota Constraints of U.S. Apparel Imports, 2001 (Million US$)



	ASIA	CBI	CHINA	NAFTA	SSA
Unconstrained	11,459	8,071	2,567	9,338	823
Constrained	12,968	1,311	3,676	47	129

SOURCE: *Calculations based on data from the U.S. Department of Commerce OTEXA office.*

Figure 5
U.S. Apparel Imports, by Source and Risk Level, 2002-2005 (Percent and US$ Million)



	NAFTA	SSA	CBI	ASIA	CHINA
Low	876	21	1,049	3,997	2,749
Medium	47	129	1,311	12,768	3,189
High	8,461	802	7,021	7,662	304

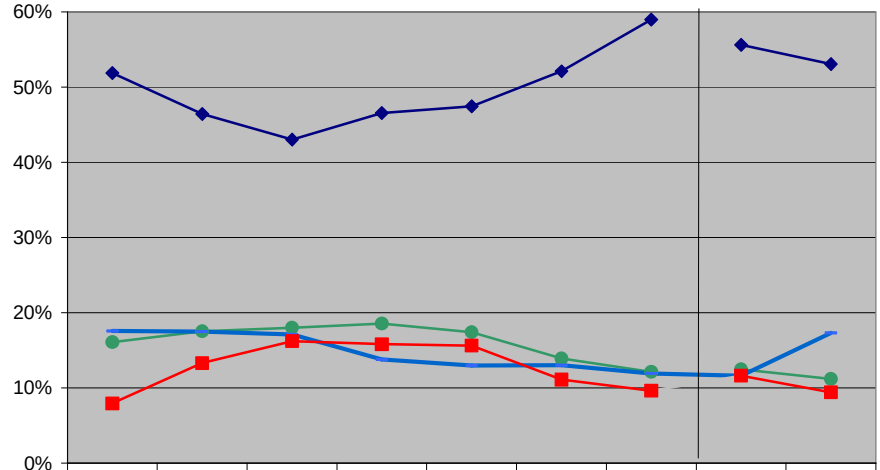
SOURCE: *Calculations based on data from the U.S. Department of Commerce OTEXA office.*

An important message of this risk analysis is that the market position of U.S. "preferential" suppliers, under NAFTA, AGOA, and CBI in particular, is highly dependent on the quotas constraining Asian and Chinese exporters. Preferential suppliers to the EU are likely to find a similar pattern; quotas restricting Asian suppliers provide a shield from competition for a majority of preferential exports. All three preferential supplying groups will likely see

dramatic increases in competition from Asian and Chinese exporters immediately after and well beyond 2005. The message for the Asia region (excluding China) is mixed. Asian exporters stand to gain U.S. market share from more vulnerable regions. At the same time, more than 25 percent of Asian exports to the United States are in the high-risk category, pointing to the possibility of substantial market share losses. China, a formidable apparel exporter, is the most likely to gain market share in the 2002–2005 period and beyond to the detriment of other regions. When the U.S. International Trade Commission (USITC) modeled the effects of quota removal on all WTO members, it concluded that all regions of the world would *lose* market share to China (USITC 1999).

Data for the first quarter of 2002 appear to corroborate this conclusion. Figure 6 shows market share, by supplying region, of all apparel products for which quotas were eliminated in Stage II (1998)—a total market of more than US$3 billion. A key pattern, as suggested earlier, is that the market shares of quota-constrained suppliers—principally Asia—increased markedly after 1998. Meanwhile, the market shares of non-quota constrained suppliers—NAFTA and the CBI—dropped by an average of one-third between 1997 and 2001. Most ominous for other suppliers, between the first quarters of 2001 and 2002, China's market share increased by 5 percentage points, while other suppliers' market share declined.

Figure 6
U.S. Import Market Share for Apparel Products Having Quotas Eliminated in Stage II (1998), 1995–2002 (Unit Market Share in Percent)



	1995	1996	1997	1998	1999	2000	2001	2001-Q1	2002-Q1
ASIA	52%	46%	43%	47%	47%	52%	59%	56%	53%
CBI	16%	18%	18%	19%	17%	14%	12%	12%	11%
CHINA	18%	17%	17%	14%	13%	13%	12%	12%	17%
NAFTA	8%	13%	16%	16%	16%	11%	10%	12%	9%

SOURCE: Calculations based on data from the U.S. Department of Commerce OTEXA office.

3. China's WTO Accession

China was not a member of the WTO at its inception in 1995 as the successor to the General Agreement on Tariffs and Trade (GATT). Consequently, it was not entitled to the benefits of the ATC and the elimination of quotas. But in December 2001, China became a member of the WTO and was granted ATC benefits including the phase-out of textile and apparel quota constraints by 2005. A World Bank study of China's accession to the WTO concluded that by 2005 China would obtain nearly 45 percent of the world market for textile and apparel exports (Ianchovichina, Martin, and Fukase 2000). Developing country exporters are already feeling the effects of China's accession to the WTO with many thousands of unskilled jobs "shifting" to China—a trend that will almost certainly continue in the coming years.

China's Competitive Advantage

In considering China's enormous potential to dominate developed-country import markets for apparel, the USITC highlighted the following:

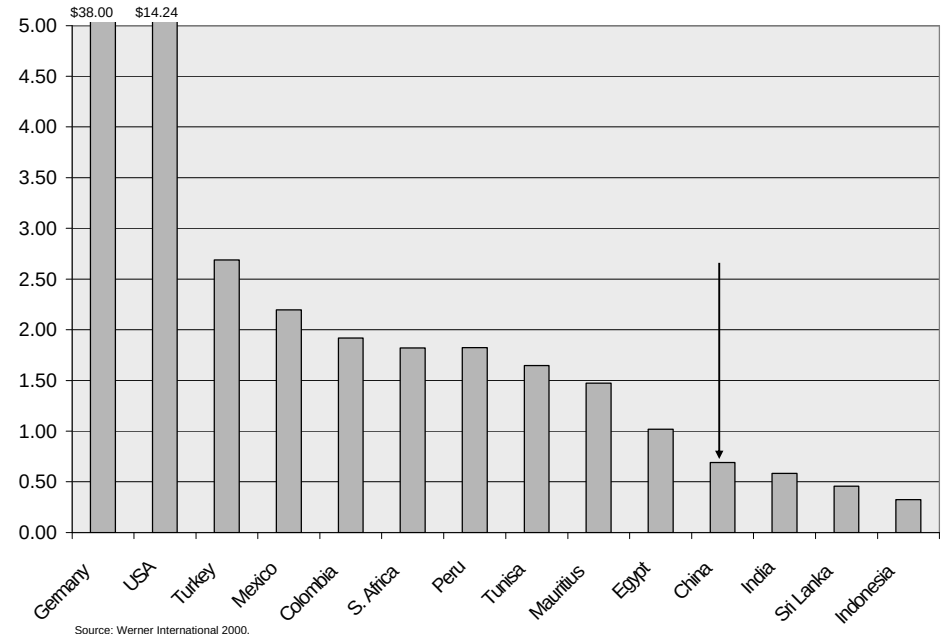
- China exports nearly one-half of its apparel production, but of this figure, only about one-third of Chinese exports arrive in EU and U.S. major markets;
- China has the world's largest production capacities for cotton, man-made fibers, and silk;
- More than one-half of Chinese apparel exports are made from high-quality imported fabrics—principally from South Korea, Taiwan, and Japan; and
- Chinese textile and apparel industries benefit to a large extent from the marketing, managerial, and financing abilities of foreign investors (USITC 1999).

Hourly wages further highlight China's low-cost capabilities. Based on hourly wages, China ranks among the lowest-cost suppliers, and in some cases its wages are one-fourth those of other developing countries supplying textiles and apparel to developed-country markets (see Figure 7).[10] Although wage costs are not the sole determinant of competitiveness in apparel

[10] Wage rates in Vietnam, Laos, and Cambodia are likely even lower than those reported here, but these countries are not members of the WTO and their apparel exports will continue to be constrained by quotas.

production, China is well placed for many other factors that contribute to overall competitiveness, such as productivity, management skills and technology, non-wage labor costs, overtime and shift differentials, transportation costs, material costs, inventory management, and, of course, product quality.

Figure 7
Hourly Wages in Selected Textile-exporting Countries, 2000



SOURCE: *Werner International.*

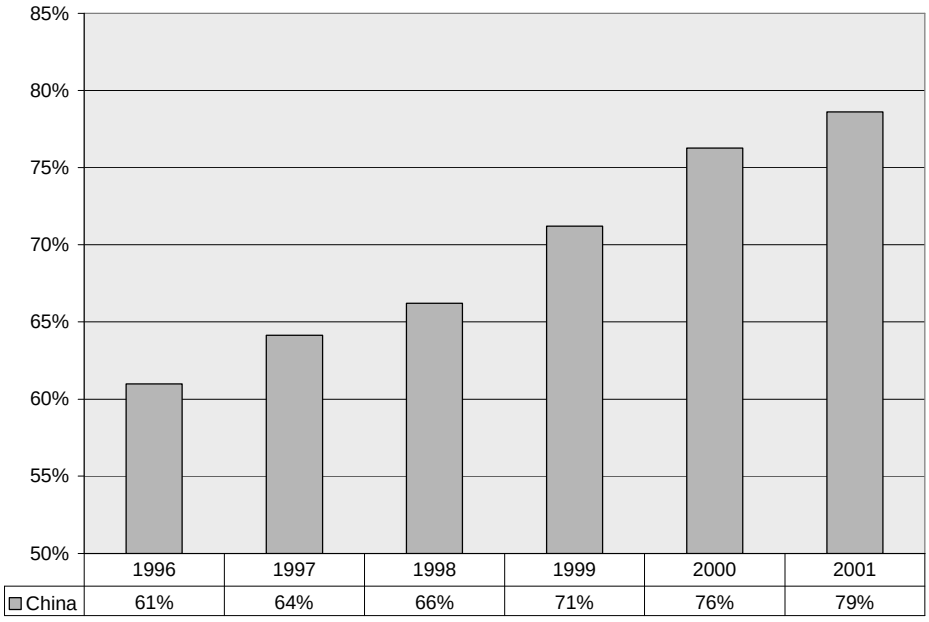
China has made great strides in sector productivity in the last five years. Output in the Chinese clothing sector rose by 37 percent from 1995 to 1999, while industry employment actually fell by 27 percent (UN 2002). China's efforts to increase productivity in the apparel industry stand in contrast to the situation in South Asia, where investment has stagnated and structural reforms have been slow (James, Ray, and Minor 2002b; Weerakoon and Wijayasiri 2000; Kathuria, Martin, and Bhardwaj 2001). Despite progress in the clothing sector, the Chinese textile industry is still considered to be outdated and inefficient. Chinese clothing producers have compensated for the low quality of domestic textiles by getting more than half the material for their high-quality exported apparel from overseas.

China's Performance in the U.S. and Japanese Markets

Beyond indicators of China's cost competitiveness and structural reforms, its recent performance in the U.S. and Japanese markets offers valuable insights into future trends. China's success in Japan, where imports are not subject to quotas, supports the conclusion

that China is the benchmark by which world apparel producers will have to measure themselves (see Figure 8). Japanese consumers are widely recognized as quality-conscious, and China's nearly 80 percent share of Japan's imported apparel market leaves little doubt that the country can supply high-quality apparel to developed countries.

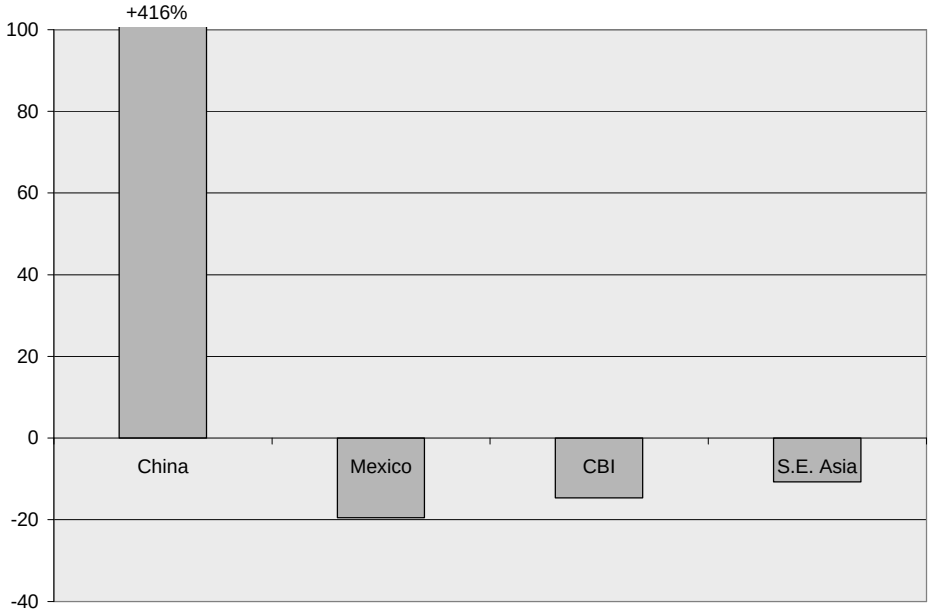
Figure 8
China's Share of Japanese Apparel Imports (by Value), 1996-2001



SOURCE: *Japanese Ministry of Finance.*

Chinese products for which constraining quotas were eliminated in 2002 met with equal success in the U.S. market. During the first half of 2002, exports from China increased by at least 100 percent in 12 out of 18 constrained categories that had quotas at least partially eliminated in 2002. For many of these categories, imports from China grew at twice that rate. For example, U.S. imports of luggage and handbags exceeded $1.6 billion in 2001—the largest product category for which quotas were eliminated in 2002. Figure 9 shows the change in market shares for the major suppliers of these products after quotas were eliminated on January 1, 2002. China's exports to the United States soared by more than 400 percent over the period, giving the country a 60 percent market share. In approximately 6 months, Chinese producers succeeded in ousting longstanding Asian and North American exporters alike, shifting thousands of unskilled jobs from nearly every region of the developing world to China.

Figure 9
U.S. Imports of Luggage and Handbags, Change in Import Shipments from the First Half of 2001 to the First Half of 2002



SOURCE: *Calculations based on data from the U.S. Department of Commerce OTEXA office.*

4. Preferential Access

A variety of agreements provide for preferential access to major textile and apparel markets. Some are reciprocal free trade agreements (FTA) in which partner countries agree to open their markets to each other according to an agreed schedule. Others are preferential trading agreements (PTA) usually between developed and developing countries, including such programs as the Generalized System of Preferences (GSP) and the European Union's Cotonou Agreement—the successor to the Lome Convention. A third group is comprised of "production-sharing arrangements" provided unilaterally by a developed country with benefits defined for a limited time, usually less than 10 years.[11] Producers taking advantage of production-sharing agreements frequently seek short-term benefits from the "assembly" of apparel parts cut in importing countries. All of these types of agreements have proliferated in recent years.

For example, the U.S. African Growth and Opportunity Act (AGOA) implemented in late 2001, gives quota and tariff preferences to apparel imports from sub-Saharan African countries[12] with special privileges applying to sub-Saharan suppliers defined as least developed countries (LDC).[13] The EU has eliminated quotas on textiles and apparel from Sri Lanka, Pakistan, Ukraine, and Bosnia–Herzegovina in exchange for reduced tariffs on EU textiles imported into these countries. The EU is in similar negotiations with Thailand and the Philippines. Moreover, many Eastern European countries are awaiting accession to the EU,

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[11] As early as 1980 producers in developed countries started relocating the most labor-intensive segments of apparel production, principally sewing, to developing countries. By using developed country fabric in the offshore production process, producers could deduct the cost of fabric from the dutiable value imported, thereby enhancing the cost-competitiveness of apparel "assembled" offshore. Production-sharing arrangements have grown in geographical scope to include countries from the Caribbean, Central America, Africa, South America, and Asia.

[12] To be eligible for AGOA preferences, countries must demonstrate progress in a number of areas, such as establishment of a market-based economy, elimination of barriers to U.S. trade and investment, protection of workers' rights, effective systems to combat corruption, and protection of intellectual property rights. Eligibility under AGOA's apparel provisions requires an effective visa system and an enforcement mechanism to prevent illegal transshipment. Qualifying countries have the opportunity, through September 30, 2008, to export apparel to the United States at preferential rates of duty, provided they meet certain rules for the source of the fabric used in the apparel.

[13] A special rule under the apparel provisions of AGOA permits least developed countries to ship apparel duty free to the United States until September 30, 2004, regardless of the source of the fabric used in the apparel.

including removal of textile and apparel tariffs. In 2001 the EU concluded a free trade agreement with Mexico.

In the United States, the potential impact of a Free Trade Area of the Americas (FTAA) on regional textile and apparel industries is enormous. In addition to becoming more competitive as a result of the liberalization of trade restrictions, producers in the Americas are also likely to gain from increased investment in the region because PTAs would no longer need to be periodically renewed.

In each of these preferential agreements, suppliers are given generous quotas and enjoy reduced tariff rates. In the United States, for example, NAFTA partners enjoy a near-zero duty on textiles and apparel entering the U.S. market; CBI partners pay an average of 6 percent, and sub-Saharan African countries face a tariff averaging about 11 percent.[14] Average applied tariffs on non-preferential suppliers range between 12 and 17 percent—depending on the product mix (see Table 3). Preferential suppliers to the United States and EU account for approximately one-third of apparel imports in each of the markets (see Figure 10).

Table 3
U.S. Trade-weighted Applied Tariffs on Textiles and Apparel, by Supplying Region, 2001

Non-Preferential Suppliers		Preferential Suppliers	
Region	Applied Duty 2001 (%)	Region	Applied Duty 2001 (%)
Asia	17	CBI (Production Sharing)	6
China	12	NAFTA (FTA)	0
Other	15	SSA\AGOA (Production Sharing)	11

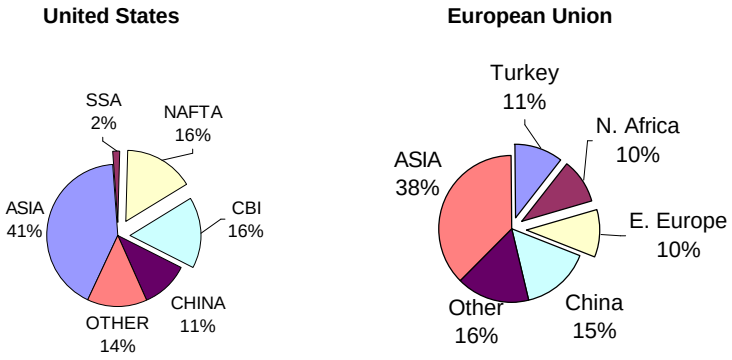
SOURCE: US Department of Commerce Imports of Merchandise Trade, 2001.

Preferential Trading Agreements

Preferential trade agreements have encouraged apparel production in beneficiary countries. And proliferation of preferential agreements has widened the disparity between producers that have such an agreement and those that do not. Producers that enjoy the benefits of a preferential agreement have often been able to accelerate growth in textile and apparel exports. Meanwhile, non-preferential producers have been increasingly marginalized, caught between the large, low-cost producers in Asia and preferential supplier countries elsewhere

[14] Because AGOA is relatively new (effective October 2001) sub-Saharan African countries have only acquired partial benefits. In other words, the trade-weighted tariff rate will fall as more trade comes under the provisions of AGOA. Also, recent changes in the CBI program will reduce trade-weighted applied tariffs.

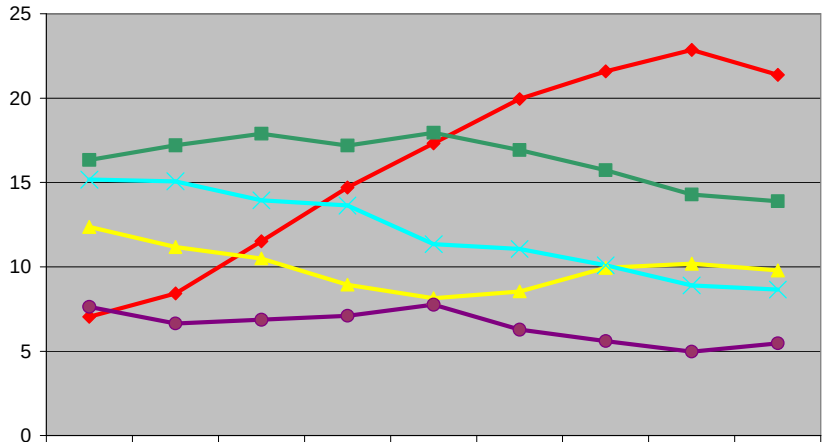
Figure 10
U.S. and EU Import Market Shares for Apparel, 2000



SOURCE: *U.S. Department of Commerce and the WTO.*

Preferential trade agreements can generate rapid growth in target country market share as exemplified by cotton non-knit apparel (see Figure 11). The NAFTA agreement gave Mexico preferential access to the U.S. market in 1994, and since then Mexico's U.S. market share tripled while all other suppliers lost market share.

Figure 11
U.S. Market Share for Cotton Non-Knit Apparel, 1993-2001



	1993	1994	1995	1996	1997	1998	1999	2000	2001
NAFTA	7	8	12	15	17	20	22	23	21
CBI	16	17	18	17	18	17	16	14	14
S.E. Asia	12	11	11	9	8	9	10	10	10
Hong Kong	15	15	14	14	11	11	10	9	9
China	8	7	7	7	8	6	6	5	5

SOURCE: *Calculations based on data from the U.S. Department of Commerce OTEXA office.*

All preferential trade agreements have rules of origin requiring the use of the importing or producing partner's yarns, fabrics, and dying. (see Exhibit 1) This is a disincentive for the use of non-preferential textiles in products destined for trade with PTA partner countries. For example, it is a disincentive for expanding apparel producers and exporters such as Mexico,

Exhibit 1
Rules of Origin: The Fine Print of Trade Agreements

Rules of origin are a pivotal part of preferential trade agreements in textiles and apparel. They restrict the use of non-regional components in goods claiming preferential treatment. In textiles and apparel trade, rules of origin usually require regional "yarn forward," necessitating the use of regional yarns in knitting and weaving of fabrics in apparel. A notable exception is the least-developed country provision in the AGOA agreement. This provision permits the use of "third country" (i.e., neither U.S. origin nor sub-Saharan African origin) fabric in apparel imported into the U.S. market from sub-Saharan African countries with average incomes of less than US$1,500 in preferential imports to the United States. This provision has provided a crucial base from which these countries can boost their exports because of the limited availability of quality regional fabrics in Africa and the high cost of importing U.S. fabrics and components. This critical provision is scheduled to expire in October 2004. When it does, LDC apparel exporters will need to have regional (or U.S.) sources of textile inputs to qualify. Apparel manufacturers considering locating manufacturing facilities in Africa—or to remain there, if they have already invested in the region—have a narrow window of opportunity to take advantage of the tariff preferences under AGOA. Unless the problem of obtaining reliable and high-quality textile inputs in the region can be addressed, exports and employment in countries dependent on this provision will suffer.

the Caribbean, and Africa[15] to use yarns and fabrics from third countries in Asia and South America.

Quota System Phase-out

When the quota system is phased out, preferential trading agreements will become less important to producers deciding where to locate assembly operations. Preferential agreements will still provide tariff benefits but they are far less significant than quotas. Tariffs in the textiles and apparel sector, although high when compared to other traded manufactures, are not as prohibitive as quotas. The average U.S. duty on apparel items is 17 percent; the tariff equivalent of quotas has been estimated to be more than twice that.

Thus, for apparel products dutiable at the average tariff rate or lower, producers receiving preferential access have only a thin margin of preference over producers not receiving preferential access—a margin that may be less than the production cost advantage that large

[15] An exception to this general rule is found in the AGOA agreement that permits qualifying least-developed countries to use non-regional formed fabric through 2004.

Asian suppliers may enjoy. Countries that have developed sizable apparel assembly operations linked to preferential trade agreements to the U.S. and EU markets may lose significant apparel manufacturing capacity as investors search for locations that offer cost and other advantages.

In the post-quota environment, many regional suppliers of apparel will find that using higher-cost regional yarns and fabrics no longer makes sense; that higher production costs exceed any tariff advantage to be gained. They may choose to forgo preferential trade agreements in order to source a wider variety of lower-cost non-regional materials. Regional suppliers of fabrics will therefore experience lost revenues when quotas are eliminated.

In short, preferential trade agreements are not a substitute for a country rethinking its sectoral competitive advantage, particularly if it depends heavily on apparel exports.

5. Trade Remedies

The rules-based WTO trading system provides for the use of trade remedy mechanisms to prevent anticompetitive trade practices. Because the quota system provided a means for managing trade, trade remedies have not been widely used to date in textile and apparel trade with the major developed markets. But with the removal of quotas, governments may increasingly look to their safeguards and antidumping laws to preserve what they consider to be "fair and orderly" trade. Application and removal of these trade remedies can result in sudden changes in market share.

Antidumping and Countervailing Duties

An important result of quota removal has been a rapid rise in global exports and an associated drop in average import prices in major international markets (see Figure 12). As exporters compete for market share in the new competitive environment, the trend will be toward lower prices, perhaps below long-term costs. Additionally, a government concerned with loss of unskilled labor jobs will be tempted to use subsidies. WTO rules governing the use of trade remedies allow importing countries to apply duties on imports of products sold "at less than normal value." As markets adjust to the new environment created by the removal of quotas, governments in developing and developed countries may increasingly turn to trade remedies.[16]

Developing countries, seeking to limit their exposure to trade remedy actions (e.g., antidumping investigations), have proposed revisions to the ATC to restrict the use of trade remedies in the first few years after all textile and apparel quotas have been removed. They

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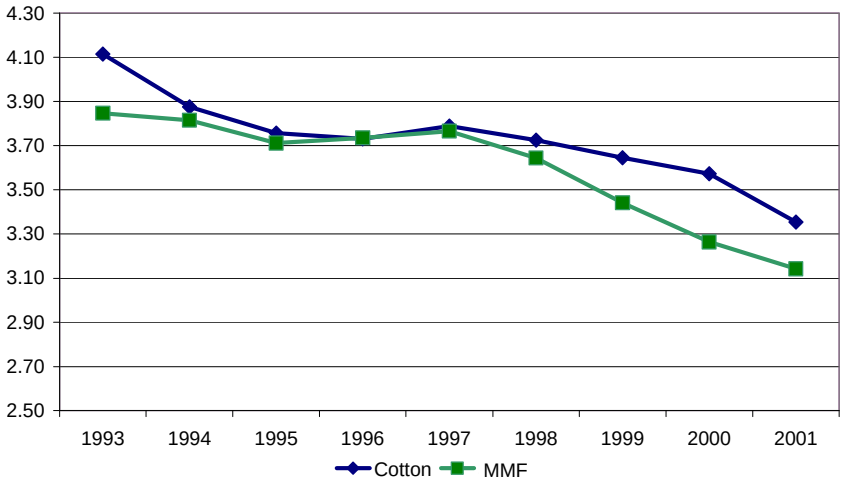
[16] There is considerable debate among WTO members on existing AD/CVD rules. Developing countries often claim that antidumping investigations flooded the WTO in the first few years after the ATC was implemented, and that initiation of each antidumping proceeding hampers their exports regardless of whether a finding of dumping is ultimately reached. But during 1996–1998, most antidumping investigations were initiated by the EU, which took action in 24 antidumping cases on textiles or clothing, mainly against Asian suppliers. The United States initiated no antidumping actions on textiles or clothing during this period. Developing countries themselves—including India, South Africa, Argentina, and Turkey, among others—initiated antidumping actions pursuant to the ATC. (Nathan Associates 2001)

Figure 12
Real Average Unit Prices of U.S. Imports of Cotton and Manmade Fiber Apparel, 1993–2001



Note: Real average unit values were calculated by adjusting nominal import values by the U.S. consumer price index (CPI).

SOURCE: Calculations based on data from the U.S. Department of Commerce OTEXA office and U.S. Department of Labor.

have also proposed a one-year waiting period for filing a new antidumping petition in the event a petition failed, contending that they could otherwise face an endless series of nuisance petitions, which would create onerous expense, not to mention market uncertainty, for their textile and apparel exporters (Nathan 2001).

China-Specific Safeguards

China's accession agreement includes two strong provisions that may be invoked in response to import surges of Chinese textiles and apparel. The first is a *sector-specific safeguard* affecting textiles and apparel that allows the importing country to apply restraints on import increases that are "due to market disruption, threatening to impede the orderly development of trade in these textiles and apparel products."[17] It provides one year of protection and can be renewed after increasing the restricted level of trade by 7.5 percent. The textile and apparel safeguard will be available through 2008, and China will not have a right to retaliate.

The second provision is the *product-specific safeguard* that can be applied against any surge in imports from China.[18] Unlike the sector-specific safeguard, the product-specific safeguard can be applied only after an investigation or due process has determined that China's exports are "the cause" of market disruptions. Although the product-specific safeguard will require a higher threshold of evidence and proof, its protection can be maintained for 3 years with the

[17] WTO Working Party Report on the Accession of China, paragraph 242 (a).
[18] WTO Working Party Report on the Accession of China, section 13.

possibility of a 2-year extension. Producers will have recourse to the product-specific safeguard for 12 years after 2005.

IMPLICATIONS FOR DEVELOPING COUNTRIES

Application of a safeguard specifically against China can have repercussions for other developing country importers. A temporary restraint on China may provide other developing countries not restrained by quotas or safeguards with brief and probably unpredictable periods of valuable market opportunities. But it appears unlikely that importing countries will apply a safeguard restricting imports from China without contingency plans to restrict surges in imports from other developing countries. Antidumping and countervailing duty measures might be applied against other developing countries in tandem with safeguards against China. China-specific safeguards might last from 1 to 3 years, whereas an antidumping duty usually lasts 5 years or more, potentially putting developing countries at a long-term disadvantage with China, unless the China-specific safeguards are renewed.

6. Conclusion

While distorted by quotas and other restrictions, international trade in textiles and apparel has been stable for the past 30 years. But events on the horizon will bring exceptionally rapid change to the apparel industry, where producers are known to "pack up" their equipment and move across a border on a moment's notice. The textile industry, in contrast, is far less mobile. However, there is tremendous overcapacity associated with outdated machinery in many countries. Producers with outdated textile machinery will attempt to sell as much as they can before retiring old equipment, forcing prices below sustainable levels. Others are likely to exit the textile industry soon after 2005. It will take several years for the global textile industry to stabilize. The potential for trade remedies adds a volatile component to these changes, making forecasting especially difficult. Even the best planning will involve a high degree of uncertainty.

No one-size-fits-all solution exists for developing countries involved in textiles or apparel production or a combination of the two. Some countries will seek to shore up their production capabilities in these industries by

- Creating free trade zones to reduce the costs of using higher quality and cheaper imported components;
- Lowering duties on raw materials and inputs;
- Streamlining duty drawback programs;
- Aligning labor regulations, such as restrictions on employee severance, wages and mandatory benefits, with world standards;
- Improving labor productivity through worker training and labor legislation (permitting piece work for example); and
- Improving physical infrastructure (electricity, transportation, and water, etc.).

Many less-competitive countries will also need to focus on strategies for diversifying into other labor-intensive sectors where they may be more competitive. Either approach can help cushion the impact of the changes in the global environment for trade in textiles and apparel.

Countries that do not take either approach will be unprepared for the adjustments that will be forced on them.

If unskilled workers dislocated by these events are not re-employed within a reasonable period, poverty, crime, and migration may increase. Workers lucky enough to retain their jobs may be pressured to work longer hours at reduced wages and benefits (e.g., health care and education). All of these changes are important to USAID missions, which might provide immediate assistance in a number of areas. Such assistance might include the following activities:

- ***Conduct a competitive assessment.*** The textile and apparel industry encompasses a large number of products and markets. A product- and country-specific competitive assessment may be conducted to evaluate a country's risk exposure, taking into account competitiveness factors such as
  - Quota constraints on international competitors;
  - Preferential trade agreements provided to regional suppliers;
  - Wage and non-wage labor costs;
  - Labor productivity;
  - Infrastructure (access and costs of electricity, water, communications, and local transportation);
  - International transportation cost and lead times;
  - Corporate tax rates;
  - Customs procedures;
  - Access to competitively priced raw materials, yarns, and fabrics;
  - Political and economic conditions; and
  - Access to foreign capital and management and marketing expertise.

- ***Provide trade capacity-building assistance in the textiles and apparel sector.*** Improved knowledge of trade policy, trade rules, and the status and process of ongoing global and regional trade negotiations will help officials from developing countries (1) negotiate or maintain tariff preferences to developed markets, (2) adhere to international laws, (3) prohibit subsidies to labor and industries in their own country, (4) create efficient and credible customs procedures by eliminating transshipments and processing of duty and tax rebates expeditiously, and (5) provide access to quality imported materials at competitive prices.

- ***Help maintain international labor standards.*** As developing countries attempt to compete in world markets, pressure will increase to lower the working conditions of textile and apparel industry workers below international labor standards. Many buyers in developed countries are concerned about the labor practices of apparel producers. A country's long-term ability to export textiles and apparel to developed countries will depend on its reputation to produce cost-competitive apparel and maintain international labor standards. USAID missions can help instruct local manufactures in basic International Labor

Organization (ILO) standards and alert buyers to systematic and egregious violations of these.

- ***Support trade diversification strategies***. In many high-risk countries, it will be important to identify opportunities to diversify into other labor-intensive industries in which local producers are more likely to have a sustainable competitive advantage in international trade. Such strategies may call for a broad range of trade capacity building assistance to improve the overall environment for trade and investment, such as projects that help to privatize and improve the quality and lower costs in transportation, telecommunications, and other key services sectors; strengthen the transparency, predictability and quality of commercial laws and institutions; reduce customs and other trade transactions costs; and improve access to information and analysis on international market opportunities.

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